

## CFTC Adopts Internal Business Conduct Standards for Swap Dealers and Major Swap Participants

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**O**n February 23, 2012, by a 3-2 vote, the Commodity Futures Trading Commission (CFTC) adopted rules (the Rules) to implement an array of swap reforms called for by six different sections of the Commodity Exchange Act (CEA), as amended by the Dodd-Frank Act:

- CEA §§ 4s(f) and (g) (imposing reporting, recordkeeping and daily trading requirements for Swap Dealers (SDs) and Major Swap Participants (MSPs));<sup>1</sup>
- CEA §§ 4d(d) and 4s(k) (requiring Futures Commission Merchants (FCMs), SDs and MSPs to designate a qualified Chief Compliance Officer (CCO) to perform enumerated duties);
- CEA § 4s(j) (mandating risk management policies and procedures for SDs and MSPs); and
- CEA §§ 4d(c) and 4s(j) (establishing conflict-of-interest requirements for Introducing Brokers (IBs) and FCMs and for SDs and MSPs, respectively).<sup>2</sup>

The Rules will (i) require SDs and MSPs to keep enumerated records; (ii) establish CCO qualifications and duties for FCMs, SDs and MSPs; (iii) prescribe requirements for SD and MSP risk management programs; and (iv) dictate procedures for SDs, MSPs, FCMs and IBs to prevent conflicts of interest. Dissenting CFTC Commissioner Scott O'Malia found the CFTC's cost-benefit analysis of these rules so inadequate that he sent a letter to the Office of the Management and Budget requesting they review the analysis.

### More Recordkeeping Requirements for SDs and MSPs

The CFTC previously adopted rules requiring each SD and MSP to “keep full, complete, and systematic records, together with all pertinent data and memoranda” of all activities relating to its business with respect to swaps until any relevant swap has been fully terminated for five years. *See* CFTC Rule 45.2; *see also* “[The CFTC's New Swap Reporting and Recordkeeping Requirements](#),” Skadden Client Alert (January 17, 2012). In adopting that general recordkeeping duty, the CFTC reserved the issue of prescribing specific documents that SDs and MSPs must keep.

In the Rules, the CFTC now lists a plethora of particular records that SDs and MSPs must retain, including: (i) transactional records for each swap transaction and position; (ii) daily trading records for all executed swaps and all related cash or forward transactions; and (iii) business records relating to governance, financials, marketing or complaints. The Rules also will require an SD or MSP to keep all information and data

1 The CFTC has not adopted final rules defining SDs and MSPs. The next meeting where the CFTC could adopt these rules is scheduled for March 20.

2 SD and MSP Recordkeeping and Reporting, Duties, and Conflicts of Interest Policies and Procedures; FCM and IB Conflicts of Interest Policies and Procedures; SD, MSP, and FCM CCO, 77 Fed. Reg. \_\_\_\_ This client alert is based on, and cites to, the unofficial version of the Rules, which is available on the CFTC's website. The official version has not yet been published in the Federal Register. The Rules also more briefly addressed supervision, business continuity and antitrust considerations for SDs and MSPs.

that the SD or MSP is required to report to a Swap Data Repository (SDR) under previously adopted reporting rules. (The SDR also is required to keep these records.) While records may be kept on an aggregate basis and need not be kept separately for each transaction, records must be searchable and identifiable by transaction and counterparty. Like the reporting rules adopted in December, any records required to be kept by these Rules must be made available for inspection by the CFTC and certain other federal agencies, upon request.

### **Chief Compliance Officer and Compliance Report Requirements**

Each FCM, SD and MSP must designate an individual to serve as its CCO. The CCO shall be appointed by, report directly to, have her or his compensation approved by, meet annually with, and can only be removed by, the board of directors or the “senior officer”<sup>3</sup> of the FCM, SD or MSP. The CFTC departs from the CCO rules adopted for SDRs by allowing the CCO of an FCM, SD or MSP to be a member of the registrant's legal department or its general counsel. The CCO's significant duties include:

- i. Administering the FCM/SD/MSP's policies and procedures reasonably designed to ensure compliance with the CEA and CFTC regulations;
- ii. In consultation with the board or senior officer, resolving any conflicts of interest;
- iii. Taking reasonable steps to ensure compliance with the CEA and CFTC regulations;
- iv. Developing procedures for corrective actions for noncompliance; and
- v. Conducting an annual review, and preparing and furnishing to the CFTC an annual compliance report.

Before providing the annual compliance report to the CFTC, the board of directors or senior officer must first review the report. Either the CCO or the chief executive officer must certify that, to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual compliance report is accurate and complete. The annual report generally covers the FCM/SD/MSP's policies and procedures, an assessment of the effectiveness of these policies and procedures, any material noncompliance issues, and a description of financial, managerial, operational and staffing resources set aside for compliance.

### **Required SD/MSP Risk Management Program**

Each SD and MSP must establish a risk management program for its swaps activities and all affiliate activities. The risk management program must be documented, approved by a governing body of the SD or MSP, and submitted to the CFTC. As part of the program, the entity must have a “risk management unit” that reports to senior management. The “risk management unit” is not required to be a formal unit of the business. Risk management personnel may serve other functions, but the risk management unit must be kept separate from what the CFTC calls “business trading functions” of the entity.

Although some specifics of how to implement the risk management program are left up to the SD/MSP, the CFTC has prescribed required elements of the program as well as means by which many of those elements must be addressed. Notably, the risk management program must include:

- i. Quarterly risk management reports submitted to both senior management and the CFTC;
- ii. Procedures for assessing the risks associated with new products;

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3 The CFTC elects not to define the term “senior officer.” See p. 133-134.

- iii. Limitations on the operation of the SD/MSP's business trading unit;<sup>4</sup>
- iv. Monitoring, testing and recordkeeping; and
- v. Monitoring of compliance with position limits.

Further, an SD/MSP's risk management program must take into account specific types of risk: market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk and settlement risk. Additionally, the new rules set forth specific requirements for monitoring these risks, in many cases requiring daily measurement of risk exposure.

An SD/MSP cannot avoid compliance with these requirements by clearing its swaps. In fact, if an SD/MSP clears its swaps, the new rules require it to diligently investigate the adequacy of financial resources and risk management procedures of its chosen clearinghouse. Further, an SD/MSP must establish policies regarding its use of clearing, including setting forth conditions for the voluntary use of clearing as a means of mitigating counterparty credit risk.<sup>5</sup>

### **Required Procedures for Avoiding Conflicts of Interest**

The new conflict-of-interest provisions apply not only to SDs and MSPs, but also to FCMs and IBs, although small IBs are almost completely exempt. The Rules require both additional disclosures of potential conflicts of interest and separation of particular business units. More specifically, the new rules require that research analysts remain separate from non-research personnel and that clearing functions remain separate from affiliated business trading units. The CFTC has set forth requirements as to how these separations must be accomplished.

As to the separation between research analysts and non-research personnel, among other requirements, non-research personnel may not review or approve a research report for publication, influence a decision to publish a research report or direct the views stated in such a report. Non-research personnel may verify accuracy of facts and provide non-substantive edits, but only if their communications involve legal or compliance personnel. The board of directors or any committee thereof, however, may review and approve a research report. Further, communications from a research analyst to a current or prospective counterparty must not omit any material fact or qualification that would cause the communication to be misleading.<sup>6</sup>

The CFTC believes that separation between an FCM clearing unit and affiliated SD/MSP is crucial for maintaining open access to clearing. As such, no SD/MSP may interfere in, or attempt to influence the decision of, an affiliated FCM to provide clearing services to a customer, including, but not limited to, influencing risk tolerance levels for a customer. Also, an FCM must maintain a separation, including an "informational partition," between its clearing unit personnel and the business trading unit of an affiliated SD/MSP, although the business trading unit may participate in default management. Most notably, no employee of a business trading unit may review the provision of clearing services, condition or tie the provision of trading services to the provision of clearing services or otherwise improperly incentivize the use of an affiliated FCM's clearing services. The CFTC clarified, however, that it does not regard discounting affiliated clearing services in connection with trading as "improper."

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4 A "business trading unit" performs or supervises pricing, trading, sales, purchasing, marketing, advertising, solicitation, structuring or brokerage activities.

5 The Rules do not prescribe or provide further guidance regarding the content of such policies.

6 This provision seems to be consistent with the CFTC's new anti-manipulation rules. See ["CFTC Finalizes Rules Imposing Liability for Fraud-Based Manipulation,"](#) Skadden Client Alert (July 26, 2011).